Islamic Economics and Banking in the Global Economy

Governing Firms and Financial Markets

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National and regional economies are becoming globalized to the extent where we can speak of *the* global economy. The value of exported and imported goods has reached 92 percent of the world's non-service GDP, while the total value of all exports and imports (goods and services) now accounts for nearly half of world GDP. International trade has grown to the point where currency exchanges handle nearly seven per cent of the world's GDP on a daily basis.[1]

One might reasonably expect this economic globalization to result in a convergence of market culture and institutions. Recent movement toward a globally acceptable accounting standard could be seen as one example of a trend in that direction.[2] Nevertheless, there are parochial movements in the worlds of finance and economics. Islamic economics, which categorically rejects interest and other key principals of the hegemonic financial order, and the Islamic banks that operate within it, is one such movement. But can alternatives such as Islamic economics thrive, or even continue to exist, in a world where trade and finance are becoming increasingly cross-border and cross-cultural activities? An examination of the state of Islamic finance and banking shows that the answer is a complicated yes. While Islamic economics is the subject of much criticism, it has also been quite successful in a niche of regional and global financial markets.

Critics of Islamic economics point out that while these banks are technically compliant with the letter of *sharia* law, the financial instruments favored by Islamic banks draw from the spirit

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[1] Mauro F. Guillén (2001) "Is Globalization Civilizing, Destructive or Feeble? A Critique of Five Key Debates in the Social Science Literature," *Annual Review of Sociology, 27* (235-260): 238-239.

[2] Robert Bruce, "Giant step is taken towards a single global standard," *Financial Times* (3 May 2007) <http://www.ft.com/cms/s/45ba1fe6-f928-11db-a940-000b5df10621.html> 15 May 2005.

of conventional economics.[3] Timur Kuran, of the University of Southern California, criticizes Islamic economics from another perspective, calling it fundamentalist, essentially political, and economically counterproductive.[4] Islamic economics has thrived in spite of such criticism. In 1995, twenty years after the first Islamic banks opened, Islamic financial institutions controlled assets valued at approximately $100 billion; in the last decade, the amount of money managed by Islamic banks has grown to $200 billion. Today, Islamic banks are among the top five largest banks in many Muslim countries and the entire Islamic finance industry is estimated at $750 billion. These banks have been so successful that secular banks, sensing an opportunity, have opened interest-free branches or windows in some Muslim countries. The British government recently announced that it is considering issuing *sharia*-compliant bonds.[5] Numerous Islamic financial institutions also exist in scores of non-Muslim countries, including the United States. Since 2000, the Dow Jones Islamic Fund and others have offered their services to American investors.[6] Pakistan, Iran, and the Sudan, have converted their entire banking systems to operate according to the principles of Islamic economics.[7]

In order to answer the above question, I will first offer a definition of Islamic economics and a description of the practices of Islamic banking, both ideally, and as such banks actually func-

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[3] Aggarwal and Yousef (2000) "Islamic Banks and Investment Financing," *Journal of Money, Credit, and Banking, 32* (93-120); Clement Henry Moore (1990) "Islamic Banks and Competitive Politics in the Arab World and Turkey," *The Middle East Journal, 44* (234-255); Timur Kuran (1995) "Islamic Economics and the Islamic Subeconomy," *Journal of Economic Perspectives, 9* (155-173).

[4] Kuran (1993) "The Economic Impact of Islamic Fundamentalism," in Martin E. Marty and R. Scott Appleby, eds., *Fundamentalisms and the State: Remaking Polities, Economies, and Militance*, Chicago: University of Chicago Press (302-341); Kuran (1995); Kuran (1996) "The Discontents of Islamic Economic Morality," *AEA Papers and Proceedings, 86* (438-442); Kuran (2004) *Islam and Mammon: The Economic Predicaments of Islamism,* Princeton: Princeton UP.

[5] Aggarwal Yousef (2000): 99; Institute of Islamic Banking and Insurance, "Status of Islamic Banking," <http://www.islamic-banking.com/ibanking/statusib/php> 17 May 2007; Kuran (1993): 317; *Marketplace* (21 May 2007) "Investing According to Islamic Law," WBTN (Vermont Public Radio), Bennington, VT..

[6] Dow Jones Islamic Fund, "Overview," <http://investaaa.com/> 18 May 2007; Kuran (1995): 160; Bill Maurer (2001) "Engineering an Islamic future: Speculations on Islamic financial alternatives," *Anthropology Today, 17* (8-11): 8. See also Amana Mutual Funds Trust, <http://www.amanafunds.com/> 17 May 2007, and the Institute of Islamic Banking and Insurance.

[7] Aggarwal and Yousef (2000): 93.

tion. I will then summarize the critics' argument, giving particular attention to Kuran's analysis of the history of Islamic economics. Finally, I will place the Islamic banking movement within the context of the ever-more-global economy.

Islamic economics takes as its starting point the *Quranic* ban on *riba* (generally translated as "interest"): "O you who believe. Do not gorge yourself on *riba*, doubling and redoubling it."[8] From this and other verses in the *Quran* and from the *Sunna* (stories about the life of Muhammad), Islamic economics constructs a system of prescriptions and proscriptions for conducting economic activity in accordance with *sharia* law. According to the precepts of Islamic economics, this means avoiding not only *riba*, but also un-Islamic business ventures. The Amana Mutual Funds Trust, an Islamic fund manager, says that their funds meet these requirements by avoiding "interest (*riba*) and investments in businesses such as liquor, pornography, gambling, banks … bonds and other fixed-income securities."[9]

While *riba* is generally translated as "interest," this is an imperfect translation of the word. It has a much broader meaning, and the exact nature of *riba* is the subject of much debate. Fazlur Rahman devotes a lengthy article to determining the meaning of the word, and documents a myriad of definitions. These include "to grow," "to rise," "to swell," "to nurture or raise," and "to increase."[10] It is this last meaning from which it gets its dominant meaning of "interest" or "usury," but any unjust economic gain, which must come at the expense of another's unjust loss, is *riba*. *Riba* is any gain secured without risk, payment for the time-value of money (which is seen as being risk-free), or any gain from avoiding a fair market valuation of a product. Thus, in addition to interest, arbitrage, speculation, cornering the market, using a mole to bid up an auc-

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[8] *Quran* 3:130, qtd. in Sh. Yusuf Talal DeLorenzo (2006) "Introduction to Understanding *Riba*," in Abdulkader Thomas, ed, *Interest in Islamic Economics: Understanding* Riba, London: Routledge (1-9): 2.

[9] Amana Mutual Funds Trust, "Halal Investing," <http://www.amanafunds.com/> 17 May 2007.

[10] Fazlur Rahman (1964) "*Ribā* and Interest," *Islamic Studies, 3* (1-43): 1-2.

tion, and some forms of insurance (such as deposit insurance) are *riba*. Some jurists consider indexing for inflation to be *riba*, too.[11]

Maurer explains that an action is *riba* when it "avoids the use of money and the market to allocate or moderate risk."[12] For Sohrab Behdad, it is *riba* if the goods or services are not priced at their "fair exchange value, … the market return on labor and capital."[13] This explains the prohibition on many of the actions listed above, but does not explain the ban on interest. While interpreting *riba* as interest has a basis in usurious practices institutionalized in pre-Islam Arabia, Emad Khalil offers a wider explanation, stating that the Prophet Muhammad prohibited exchanging goods for goods of the same type but of unequal quantity, irrespective of their quality.[14] A loan with interest is essentially an exchange of unequal quantities of currency. That the money returned is of a lower quality than the money lent due to its time-value is irrelevant; the exchange of different quantities of the same good is prohibited. This, then, explains the Amana Funds avoidance of investments with a fixed income.

Abdulkader Thomas offers a simple test to determine if a transaction is *riba*: 1) Either a product or a service must be delivered (money does not count as either); 2) It is only legitimate to accept a profit if you are willing to accept a risk of loss; 3) There must be a verbal or written contract; 4) No party should conceal information or try to defraud the other party; 5) Neither party may profit from *harram* (forbidden) activities, as discussed above.[15]

The financial instruments that most embody these principles are *mudaraba* and *musharaka*. Both commit the lender and borrower to a profit-and-loss sharing (PLS) relationship. This ex-

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[11] Kuran (1996): 439; Maurer (2001): 9; Thomas (2006) "What is *riba?*" in Thomas (123-134): 130.

[12] Maurer (2001): 9.

[13] Sohrab Behdad (1989) "Property Rights in Contemporary Islamic Thought: A Critical Perspective," *Review of Social Economy, 47*, retrieved from *Expanded Academic ASAP* at Crossett Library, Bennington College, Bennington, VT on 23 April 2007.

[14] Emad H. Khalil (2006) "An overview of the *Sharia'a* prohibition of *riba*," in Thomas (55-68): 58-59.

[15] Thomas (2006): 133.

poses the lender to risk, making any profits *halal*, or kosher. In *mudaraba*, the lender and the borrower engage in a joint venture in the one provides the capital, while the other provides sweat equity. The lender and the borrower split any returns according to an agreed-upon percentage stipulated in the contract. In the case of loss, the financier is liable for his financial investment, while the entrepreneur risks his time and labor. *Musharaka* is similar to *mudaraba*, except that in this case, both parties supply capital and the lender participates in the business's management. Profits are split according to an agreed-upon percentage, as before.[16] The key distinction between these PLS agreements and *riba* is that *riba* guarantees a fixed return, while the return in *mudaraba* and *musharaka* is based on a percentage, and the borrower is not financially liable to the lender in case of loss.[17]

Islamic banks face a number of disincentives to use PLS instruments, however. PLS relationships "presuppose an unusually close and trusting relationship between the bank and the borrower."[18] In the absence of such close relationships, banks face the problems of incomplete information and adverse selection. Both banks and entrepreneurs face an informational disincentive to participate in PLS. In order for the bank to be sure they are receiving their share of profits, the borrower must provide the bank with complete and accurate financial statements. However, entrepreneurs in developing countries, including many of the countries where Islamic banking is prevalent, frequently falsify their financial records in order to evade taxes. While lenders cannot accept the reduced returns caused by falsified records, borrowers may be hesitant to provide banks with accurate information, fearing that it will reach government tax authorities.[19]

Islamic banks also face an adverse selection problem. For the entrepreneur, "conventional

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[16] Aggarwal and Yousef (2000): 96.
[17] Behdad (1989).
[18] Moore (1990): 234-235.
[19] Kuran (1995): 162; Kuran (2004): 12; Moore (1990): 235.

banks should offer cheaper money then Islamic banks because they do not share as many risks. With their hands off approach, they may also better protect business secrets."[20] Creditworthy entrepreneurs, then, may turn to conventional banks for capital, leaving Islamic banks a sub-prime pool of borrowers in whom to invest.[21]

As a result, Islamic banks have never invested more than a "miniscule" amount, typically less than five percent, in PLS deals.[22] In order to minimize risk, these loans are also overwhelmingly short term, given to low-risk sectors, and are over-collateralized (which, to the extent that it eliminates risk, borders on *riba*).[23] If they avoid *mudaraba* and *musharaka*, how do Islamic banks avoid *riba*? While some institutions have come up with innovative PLS agreements,[24] most loans from Islamic banks are made in the form of *murabaha*, a loan that, while technically *halal* under *sharia* law, is effectively based on interest with a fixed return.

Murabaha, also called markup contracts, dates from the 9th century. It is an arrangement in which the lender buys an item and then immediately resells it to the borrower at a markup. However, while ownership of the item is transferred immediately, payment is deferred until an agreed-upon date or according to a negotiated payment schedule. The second sale is voided should the borrower default, allowing the lender to repossess the property. This markup is effec-

[20] Moore (1990): 235.
[21] Aggarwal and Yousef (2000): 106; Kuran (2004): 12; Moore (1990): 235.
[22] Kuran (1995): 162.
[23] Aggarwal and Yousef (2000): 105; Moore (1990): 234.
[24] American Finance House Lariba (AFHL), for example, offers a lease-to-purchase mortgage it calls a "diminishing *musharaka*." Under this arrangement, AFHL and the borrower jointly purchase a house. While the house is titled to the borrower, each party owns a portion of fictive shares in the property proportional to their initial investment. The borrower makes payments to AFHL, according to an agreed-upon schedule, to repurchase AFHL's shares in the property, with no interest added, over the period of the loan. AFHL makes its profit by charging the borrower "rent" on its shares of the property as a percentage of the market rate. The individual also pays a premium to buy back shares, and the rental payment shrinks as the borrower's share of the property grows. AFHL is exposed to greater risk through diminishing *musharaka* than a bank would be from a conventional mortgage: should the property value decline, the borrower could renegotiate the rental price (which would have a similar effect to refinancing the mortgage), lowering the monthly "rent" payment. American Finance House Lariba, "Home Financing," <http://www.lariba.com/financing/home/mail.shtm> 17 May 2007.

tively an interest payment, and often corresponds to the prevalent interest rate. However, by breaking down the sale into two transactions in which the good changes hands twice (once to the bank and once to the borrower), the sale is technically interest free. Furthermore, the bank is exposed to risk for the period of time that it owns the asset. (Of course, the bank keeps that period as short as possible, limited only by the length of time it takes to complete the second sale.) The transaction is therefore technically free of *riba*, even if only superficially so.[25]

Murabaha and similar instruments account for the overwhelming majority of financing provided by Islamic financial institutions. This is the case even though in many countries, Islamic banks face a strong incentive to use PLS instruments. In Turkey, for example, the profit from *murabaha* is taxed at 48 percent while the profits from *mudaraba* and *musharaka* are exempt from taxation. The fact that such incentives have not led to an increase in PLS loans is evidence both of the costs of incomplete information and adverse selection and of the robustness of interest as a mechanism for the market to price money and risk.[26]

The dearth of PLS in Islamic finance may be a problem for its proponents and a sign that Islamic economics offers no coherent paradigm upon which to structure an economy.[27] These inconsistencies support Kuran's assertion that Islamic finance, which he calls an "invented tradition" and a form of "cultural protectionism,"[28] is more important as a political movement than as an economic one. Kuran bases this argument largely on the history of Islamic economics.

Islamic economics began on the Indian subcontinent in the years before partition. Its founder, Sayyid Abdul-Ala Mawdudi, and the Jamaat-i Islami party he founded, opposed the creation of Pakistan on the grounds that India's Muslims needed cultural independence, rather than political

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[25] Aggarwal and Yousef (2000): 96-97, 116; Kuran (1995): 162.
[26] Kuran (1995): 163.
[27] See Behdad (1989), DeLorenzo (2006), Kuran (1995), and Thomas (2006).
[28] Kuran (2004): x; Kuran (1996): 438.

independence. Mawdudi opposed partition because he thought that political independence would make Muslims feel a false sense of security and reduce, rather than strengthen, the importance of Islam in their everyday lives.[29]

Mawdudi sought a way to make Islam a constant part of Muslims' public lives. Doing so would strengthen the *umma*, the worldwide Muslim community that is supposed to supersede national and ethnic divisions to form a community of all Muslims. For Mawdudi, Islamic economics was a way of "tightening communal bonds among Muslims."[30] His position was that

> Muslims should endeavor to strengthen their communal identity by pursuing lifestyles that would distinguish them from non-Muslims. To avoid ambiguity as to what behavior was properly Islamic, Mawdudi and his colleagues ventured to update the norms of Islamic [conduct]. Among the fruits of their efforts was Islamic economics. They tried to promote solidarity within the global community of Muslims. Muslims were to interact mostly with one another, minimizing relations with outsiders.[31]

Thus, when Mawdudi and his colleagues began articulating the requirements of Islamic economic activity, the *Islamic* component was much more important to them than the *economic* aspect – it was, after all, a way to enforce Muslims' identification with the *umma*. Banning interest, according to Kuran, was expedient because interest is central in the prevailing economic thought and to the operation of every economy in the world. By eliminating interest, Mawdudi could claim that Islamic economics and Islamic banks were "fundamentally different" from their conventional counterparts.[32]

Kuran continues his critique with an analysis of the social meaning of Islamic economics, which extends far beyond the operation of Islamic banks. Briefly, he says that there exists an Islamic subeconomy of firms with an Muslim identity that tend to do business with each other and so form an economic network. Individuals, of course, are also actors in this subeconomy. For

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[29] Kuran (2004): 84.
[30] *Ibid*: xii, 85, 94.
[31] *Ibid*: 95.
[32] Kuran (1996): 439; Kuran (2004): 82.

Muslims trying to get ahead in society, participating in a system that falls short of their own moral standards may induce feelings of guilt. This guilt is supported by a self-proclaimed Islamic economic order that fosters guilt by "characterizing certain universal economic practices as un-Islamic."[33] Kuran draws on psychological studies to show that for these individuals, participation in the Islamic subeconomy may serve the function of expiating their guilt.[34]

Participating in the Islamic subeconomy may also provide economic benefits. Not only do participant firms match their secular counterparts in productivity and the quality of their products, but members of the subeconomy also develop the close interpersonal relationships upon which many of the practices of Islamic economics are predicated. This allows business to be conducted within a network of known and trusted actors and lowers transaction and information costs. While these types of networks exist in any business community, in many cities in Muslim countries, the Islamic subeconomy is the most accessible such network, especially for recent arrivals, devout Muslims, the socially disadvantaged, and others who may not have access to the business elite.[35]

Thus, the Islamic subeconomy provides a necessary community to those in search of the economic and psychological benefits it provides. Furthermore, this community seems to possess the social characteristics that would allow for the successful deployment of *mudaraba* and *musharaka* contracts. Finally, this community, to the extent that it shares a common identity and is self-contained, seems to fulfill Mawdudi's original vision of providing a set of practices, to which Muslims can adhere, as a bulwark against the threat of un-Islamic and immoral values, assimilation, and the West.

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[33] Kuran (1996): 438.
[34] Kuran (1995): 167-168.
[35] *Ibid*: 168-169.

The reach of Islamic economics, finance, and banking, however, is far longer than that of the Islamic subeconomy. While vibrant subeconomies may exist in cities throughout the Muslim world, Islamic economics is a billions-of-dollars sector that includes at least three entire national economies, vast portions of the wealth of many other countries, and extends into Europe and the United States. While it is a logical assumption (though not addressed in the literature) that Islamic financial institutions in Western cities receive most of their business through the Islamic subeconomy, it does not follow that Iran or Pakistan operate as a subeconomy as defined by Kuran, or that one fifth of Egyptian wealth – the approximate market share of deposits at Islamic banks there in the late 1980s[36] – was controlled by subeconomy actors.

The Islamic subeconomy is likely to continue to operate effectively in the emerging global economy, as it fulfills essential economic and psychological needs for its participants.[37] Islamic financing, on the other hand, while currently thriving, has not offered a coherent economic alternative to the reigning system.[38] As globalization further links economies and cultures, will this alternative system of economics survive?

This question must be answered on two fronts. First, how different *are* Islamic economics and banking? As the preceding discussion shows, most Islamic banking transactions are, in fact, based on interest, using *murabaha* as an instrument to make them *halal*. Additionally, Islamic banks offer rates of return, albeit under names other than interest, equivalent to conventional banks.[39] Thus, whatever ideals of PLS Islamic economics espouses, in practice it is not too different from the operation of conventional banks.[40] Even though Islamic economics and conven-

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[36] Moore (1990): 236.
[37] Kuran (1995): 169.
[38] Behdad (1989); Kuran (1995): 170.
[39] Kuran (1995): 161.
[40] See, for example, Aggarwal and Yousef (2000), whose evidence suggests that “Islamic banks are niche provid-

tional economics differ, they are compatible systems.

Second, this question implies that globalization means convergence. In fact, while the global economy spreads organizational structures and institutions, such as banks, around the world, these structures take on different forms, meanings, and practices and produce different outcomes in different locations. It is worth noting that the Islamic economics owes its very existence to modern globalization. In his extensive review of the literature on globalization, Mauro F. Guillén defines globalization as "a process leading to greater interdependence and mutual awareness (reflexivity) among economic, political, and social units in the world."[41] Mawdudi saw Islamic economics as a way to combat the deleterious effects of these growing cultural and political connections.

This suggests that globalization causes something far more complex than convergence, a finding that Guillén emphatically supports. After reviewing the works of close to 20 authors, he concludes "most research either assumes or documents that globalization is indeed happening, and most empirical studies … *do not find convergence in political, social, or organizational patterns as a result of globalization*."[42] Instead, there seems to be a process of divergent convergence: while there is a "phenomenon of worldwide diffusion," a spreading of institutions, a standardization of tastes, "the experience at the receiving end … seems to be growing more diverse even as globalization intensifies."[43]

Peter Gourevitch offers a framework to understand the process by which globalization can cause simultaneous convergence and divergence. He writes of a dialectical relationship in which "global market forces are mediated by market institutions and by political processes, so that the

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ers of capital, and within that niche do not operate much differently from conventional banks."

[41] Guillén (2001): 236.

[42] *Ibid*: 254, emphasis added.

[43] *Ibid*: 252. See also page 247, where Guillén says, "globalization does not seem to compel governments, firms, and individuals to converge in their patterns of behavior."

direction of their influence can vary by country."[44] Within a single national economy, the market and the political environment are engaged in their own dialectical process, the developments in one continually shaping the other, and vice versa. While the same extrinsic forces, including the introduction of new institutions and ideas, may be acting on multiple national or regional economies, the unique dynamics of each interaction lead to a different result.

Islamic finance is an excellent example of this convergent divergence. It shares many institutions, such as banking and debt, with conventional economics. Indeed, *mudaraba* and *musharaka*, the PLS instruments of Islamic banking, closely resemble the venture capitalism that fueled the tech explosion of the 1980s and 1990s.[45] Despite these similarities, the interaction of global forces and the particular situation of pre-Partition India led to the creation of Islamic economics. Its subsequent growth was the result of specific market and political factors, especially the Gulf states' incredible oil profits in the 1970s.[46] Since the first Islamic banks opened in 1975, Islamic banking has grown rapidly, and spread across the globe. Rather than being threatened by the increasing pace of globalization, however, Islamic economics will probably continue to thrive as parochial systems "continue to find ways of diverging" in the converging global economy.[47]

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[44] Peter Gourevitch (2003) "Corporate Governance; Global Markets, National Politics," in Miles Kahler and David A. Lake, eds, *Governance in a Global Economy*, Princeton: Princeton UP (305-331): 325.
[45] Kuran (1995): 171.
[46] Kuran (2004): xiii.
[47] Gourevitch (2003): 325.

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